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# BEHIND THE WARM WELCOME

A hotel management agreement defines the scope and breath of the legal and commercial relationship between a hotel owner and a hotel operator, and SMEs should not take the negotiations of such a contract lightly

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A typical hotel management contract is made up of four documents. They are:

- A hotel management agreement for the management and operation of the hotel,
- A licence agreement for the use of the hotel brand on the hotel and for marketing and promotional purposes,
- A technical services agreement for providing expertise on the technical aspects of constructing a hotel property, and
- A centralised services agreement for the marketing and promotion of the hotel, including the use of its global reservations system.

For the purposes of this article, we will be focusing only on the management agreement and only on selected terms found in a management contract. A hotel management agreement typically weighs in at 70 to 100 pages. There are exceptions to the rule, of course. There is a major hotel operator whose hotel management agreement template is half the size of its competitors, and is often touted by that hotel operator as being “owner friendly”. But the reality is quite different. In the hotel world, for the owner at least, less is not

more especially when the owner faces the prospect of spending his money in the millions with no guarantee of any return on investment.

Thus, the hotel owner must ensure that the hotel management agreement contains the necessary controls over the hotel operator – particularly where it relates to the budgeting and spending by the hotel operator. But these “controls” are often missing from the “owner friendly” template.

The following are terms typical in a hotel management agreement: term; limitations on operator’s authority; and termination, including early termination.

**TERM**

The rule of thumb in most cases is that the more upscale the brand, the longer the term. The term is important as most hotel management agreements do not have a typical termination without cause provision that allows for early termination. This means that even if the hotel and the hotel operator are not performing up to par, the hotel owner cannot terminate the relationship.

Most international hotel operators want the operating term to be as long as possible. The typical compromise is that most operating terms will range around 10 to 15 years, depending on the hotel brand. The operating term (sometimes known as the initial term) is also usually renewable by mutual consent (or in some cases automatically) for multiples of five years, provided that written notice is given prior to the end of the current term.

**LIMITATIONS ON OPERATOR’S AUTHORITY**

Running a hotel is not an easy task. It requires a unique set of skills and experience. Common responsibilities of hotel operators include:

- Managing all of the hotel’s departments such as maintenance, front office, housekeeping, food and beverage, sales, etc, including the hire, training, paying, supervising, and terminating the employment of hotel employees;
- Establishing rates and charges for the usage of all guest rooms and collecting all charges, rents and other amounts due from guests;
- Operating and keeping the hotel in good operating order, repair and condition by arranging for the maintenance and repair of the hotel, and for the utility, telephone, security, detective agency protection, elevator, escalator, window-washing, vermin extermination, trash removal and other services necessary for the operation of the hotel;
- Arranging and providing for promotions, public relations, advertising, and marketing of the hotel; and
- Preparing monthly and annual financial statements and daily reports for the hotel owner.

All of the above and more requires massive financial funding; and that usually comes in the form of working capital. This is the amount that hotel operators will require hotel owners to deposit in an operating account to pay for necessities such as payroll, utilities and operating supplies. Failure to have the working capital in an operating account (which the hotel operator controls) is often a material breach of the hotel management agreement.

An effective hotel management agreement (if we are arguing for the hotel owner) should be able to provide

the hotel owner with the ability to have a meaningful say in the way that a hotel operator manages his hotel. This means ensuring that owners have sufficient approval rights over items such as budgeting, expenditures, the employment of key management positions, outsourcing and capital expenditure.

One form of control is the hiring and firing of key personnel such as the general manager, finance director and occasionally, the director of marketing and sales. All current hotel management agreements provide that the hotel’s employees are employees of the owner but note that the employees are hired pursuant to the hotel operator’s employment guidelines and policies. In other words, hotel owners pay for the employees but have no say on how employees are to conduct themselves on an ordinary day while working for the owner.

This is done because operators generally do not like the liability of being an employer. Thus, owners should insist – at a minimum – on the right to approve the candidate for the key positions and for the right have a say in terminating any such hires.

Another form of control for owners is having approval rights at the annual budgeting stage (where hotel operators must agree to submit an annual budget, usually 90 days before the start of a fiscal year to the hotel owner for his approval) and insisting that the hotel operators cannot deviate from the approved budget including placing restrictions on expenditure. Hotel operators must therefore obtain the consent of the hotel owner prior to entering into any major contracts that require expenditure in any given year of an agreed monetary threshold.

**TERMINATION**

What happens if a hotel owner is truly unhappy with the hotel’s financial performance and more importantly, wants to see change or an early exit?

As mentioned above, the management agreement is typically a fixed term contract; and any early termination would be construed by the operator as a material breach of contract – thereby entitling the operator to damages.

It is now common in Asia to see performance test provisions inserted. This provision allows the owner to terminate the hotel management agreement in the event that the hotel operator fails to meet an agreed performance termination threshold – for example, where the hotel’s gross operating profit is less than, say, 85 per cent of the hotel’s budgeted or forecasted operating profit for the operating year.

**CONCLUSION**

It is important to realise that the relationship between the hotel owner and the hotel operator is a long-term one. For it to be meaningful and effective – where both parties gain from the relationship – there must be a deep appreciation of not only how a hotel works but also of the owner’s objective in appointing the hotel operator.

Having said that, there is no such thing as a perfect contract. But a contract can be well negotiated with both parties satisfied that at least prior to signing and for the future, they have entered into a good relationship and with the right partner. ■

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